In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1617

CLAYTON H. SHROUT and IOLA S. Shrout, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The sole question raised by the petition is whether, under Section 166(f) of the Internal Revenue Code of 1954, petitioner[1] is entitled to a deduction for an alleged payment made in discharge of an obligation of a guarantor.

In April, 1964, petitioner, a lawyer, borrowed $21,000 from a local bank at the request of one of his clients for the purpose of completing a stock-purchase agreement which his client had entered into with a third party (Pet. 4; R. 51).[2] Petitioner signed and delivered to

[1] "Petitioner" refers to Clayton H. Shrout. Iola Shrout is a party to these proceedings because she filed a joint return with her husband.

[2] "R." references are to the record appendix in the court of appeals.

the bank his promissory note in this amount and made payment to the third party, who transferred the stock to petitioner (R. 37, 50-51). Petitioner pledged the stock as collateral for the loan (R. 51). The original promissory note was endorsed by the client.

In 1966, the client filed a petition in bankruptcy. Later that year, the bankruptcy court approved a trustees' report concluding that the client's estate had no assets, and granted him a discharge (R. 52).

When the original note had become due in November, 1964, petitioner executed a replacement note and has executed similar replacement notes on several occasions. In November, 1968, the tax year in issue, the bank requested additional security, and petitioner, with his wife, executed a mortgage note of $20,000 secured by a mortgage on their residence, as a partial replacement for the previous obligation (R. 52-53). On his 1968 income tax return, petitioner claimed a bad debt deduction of $20,000. On audit, the Commissioner disallowed the deduction. The Tax Court upheld the Commissioner's disallowance and the court of appeals affirmed *per curiam* (Pet. App. A 10-11).

Section 166(f) of the Code provides that a payment by a noncorporate guarantor, endorser, or indemnitor of a noncorporate obligation, the proceeds of which were used in the trade or business of the borrower, shall be treated as a deductible bad debt in the year the debt becomes worthless. This is an exception to the general rule of Section 166(d), which treats nonbusiness bad debts of noncorporate taxpayers as short-term capital losses.

Here, the Tax Court found that petitioner was not entitled to the benefits of Section 166(f) because (1)

he was primarily liable on the promissory note involved and cannot be considered the guarantor of his note; and (2) the replacement of the note with a mortgage note in the tax year did not constitute payment of the note. The express language of the promissory note pursuant to which "for value received [petitioner] promise[d] to pay to the order of [the bank]" together with petitioner's signature in its lower right-hand corner, indicates, as the Tax Court found (R. 50-51, 54), that he was the sole maker of the note and primarily liable for the obligation. As a result, petitioner was not within the class of persons entitled to a deduction as a guarantor under Section 166(f).

The alternative holding of the Tax Court that petitioner is not entitled to a Section 166(f) deduction because he had not paid the promissory note in 1968 is similarly correct. Contrary to petitioner's contention (Pet. 8), it is well established that the replacement of such a note with a secured note is not payment, but continues the obligation. Although petitioner urges a conflict with *Helvering* v. *Price*, 309 U.S. 409, that case in fact supports the decision below.[3] Relying on its earlier dicision in *Eckert* v. *Burnet*, 283 U.S. 140, the Court stated in *Price* (309 U.S. at 413):

> As the return was on the cash basis, there could be no deduction in the year 1932, unless the substitution of respondent's note in that year constituted a payment in cash or its equivalent.

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[3]Petitioner also alleges (Pet. 8) that *Axelrod* v. *Commissioner*, 320 F. 2d 327 (C.A. 6), conflicts with the decision below. That case, however, focused solely on the question whether the borrowed funds were used in the trade or business of the borrower.

> There was no cash payment and under the doctrine of the *Eckert* case the giving of taxpayer's own note was not the equivalent of cash to entitle the taxpayer to the deduction.

Nor is petitioner's position improved by the fact that the 1968 note was secured by a mortgage on his residence. The Court further stated in *Price* (309 U.S. at 413-414) as follows:

> Respondent urges that his note was secured, but the collateral was not payment. It was given to secure respondent's promise to pay, and if that promise to pay was not sufficient to warrant the deduction until the promise was made good by actual payment, the giving of security for performance did not transform the promise into the payment required to constitute a deductible loss in the taxable year. * * *

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

JULY 1974.